2011

China: A New (Furtive) Approach to Taxing International Transportation Income

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Citation Details

Wei Cui "China: A New (Furtive) Approach to Taxing International Transportation Income" in Michael Lang, ed, *Tax Treaty Case Law Around the Globe* (Alphen aan den Rijn: Wolters Kluwer Law & Business, 2011) 159.

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A New (Furtive) Approach to Taxing International Transportation Income

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I. Facts of the Case

On 17 June 2010 a Chinese court in the Huancui District of Weihai City, Shandong Province, accepted a lawsuit brought by Donghwa Industrial Corporation (‘Plaintiff’), a company domiciled in Incheon, South Korea, against the state tax bureau of Huancui, Weihai (‘Defendant’). A court session was held on 15 July 2010, and a judgment dated 3 September 2010 was subsequently delivered.[1] According to the judgment, on 26 October 2009 Plaintiff entered into a time charter agreement (*dingqi zuchuan hetong*) with a Chinese company in Weihai (‘Lessee’). Under the agreement, which was effective between 21 September 2009 and 20 March 2010, Plaintiff leased the ship ’Jiaodong Bright Pearl‘ to Lessee for shipping between the Waihai port in China and the Pyongtaek port in Korea. The daily rental rate was USD 13,000. Although the judgment did not elaborate on this, both Plaintiff and Defendant agreed that the agreement was a ’wet‘ lease. As confirmed by an official report discussed further below,[2] under the agreement the salaries and other expenses of the crew as well as the cost of maintaining the ship would be borne by Plaintiff. On 14 December 2009 Plaintiff submitted an application to both the Waihai City state tax bureau and the Shandong Provincial state tax

[1] Administrative judgment of the People’s Court in Huancui District of Weihai City, Shandong Province, (2010) *weihuan xingchuzi* No. 31 (hereafter the ‘Huancui Judgment’) .
[2] X. Yuan et al., ’Weihai State Tax Bureau Successfully Prevented Treaty Abuse by a Foreign Enterprise’, *China Taxation News*, 16 December, 2010, p. 1 (hereafter ‘*China Taxation News Report’*).

bureau for an enterprise income tax (EIT) exemption under the China-Korea DTC exemption for international transportation income. However, it received an oral reply that the exemption would not be granted. Therefore, a 10% withholding tax was applicable to the income received under the agreement. On 17 January 2010, Plaintiff made an EIT payment of CNY 1.802,064.95 to Defendant, representing the withholding tax liability associated with the amount of rental income Plaintiff had received up to that time.

On 6 April 2010 Plaintiff applied to the Waihai state tax bureau (which sits at the next administrative rank above Defendant) for an administrative review of Defendant's collection decision. In mid-April Plaintiff also applied for competent authority assistance with the Korean tax authority. On 24 May 2010 the Waihai state tax bureau upheld Defendant's action after an administrative review, and, as a result, Plaintiff brought the case to court, requesting the reversal of Defendant's decision and the refund of the tax paid. It is unclear what, if anything, came of the competent authority application.

A report published in the official newspaper of the State Administration of Taxation (SAT), *China Taxation News*, sheds further light on the facts and procedures of the case. According to the report, upon review of Plaintiff's application for a treaty-based exemption in December 2009, the Weihai tax authorities found it unusual that the applicant's 'Registration of Ocean Transport', issued by Korea's Ministry of Territory and Oceans, mentioned only 'ship charter' as the applicant's business.[3] Apparently, previous applicants for similar treaty-based exemptions tended to provide certificates issued by the same Korean government entity in which their registered businesses were described as 'foreign-voyage, fixed-term transportation of goods'. The certificates would further indicate the routes of operation, ports of

[3] Moreover, the tax authorities found it suspicious that in the applicant's Chinese tax registration, the business of the applicant was described as 'ship charter' and not international transportation. According to the Huancui Judgment, Plaintiff had completed a tax registration in China under the status of a non-resident enterprise, and had appointed Lessee the withholding agent for Chinese business tax and EIT. Huancui Judgment, 2.

departure and arrival, and the number of times that voyages may be carried out. The applicant's certificate gave no such further information. In the view of the Weihai tax authorities, a time charter could be regarded as generating exempt income under the international transportation article only if it was ancillary to some other business that could be more directly regarded as the operation of international transportation of passengers or goods. Because the applicant did not demonstrate engagement in such other business, the Weihai tax authorities believed that the time charter amounted to 'purely rental activity', and therefore fell outside Article 8 of the DTC.

At this point, according to the China Taxation News Report, Plaintiff sought support from the Korean Embassy in China, which also made inquiries with the SAT. The SAT referred the inquiry to Weihai. The Weihai state tax bureau conducted further inquiry, but none of the additional material provided by Plaintiff persuaded it that Plaintiff engaged in more than 'the business of rental'.[4] This led to the January 2010 assessment and payment. Thus, although the court in Huancui sits at the lowest rank of the Chinese judiciary, and although Defendant, the Huancui district state tax bureau, is located at the bottom of the Chinese tax administrative hierarchy, the tax authorities at the national level on both sides were at least notified of the case. What actions they took are at present unclear, although, as discussed in section 2 below, the SAT's recent view on the matter may be surmised.

In any event, in court, Defendant cited as the primary legal basis for its action a 'Circular 241' issued by the SAT in 1998.[5] According to that circular, international transportation income covered by Article 8 of China's DTCs includes income received by an enterprise that is ancillary to its business of

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[4] These included Plaintiff's 2009 financial statements and explanations of its other business income. It turned out that Plaintiff had no other income than what was derived under the contract with Lessee. *China Taxation News Report*, note 2 above..

[5] SAT, Notice regarding Explanations of Issues Related to International Transportation under Tax Treaties (*Guoshuihan* [1998] 241, 17 Apr. 1998). In the recent 'Bulletin Regarding the Publication of the List of Currently Effective Tax Regulatory Documents' (*SAT Bulletin* 26 [2010] 13 Dec. 2010), Circular 241 is confirmed as still effective.

international transportation. And the circular listed *’rental income derived from the lease of a ship or plane (including all equipments, staff and supplies) under a wet lease‘* as one form of such ancillary income. Given that Plaintiff did not engage in other business activities than the time charter to the Lessee, the rental income it derived was not 'ancillary' to anything. Therefore, Defendant claimed, Circular 241 implied that Article 8 of the China-Korea DTC did not apply.[6]

Plaintiff countered that Circular 241 merely intended to articulate the principles of Article 8 of the DTC as well as customary international practice. It furnished to the court a Chinese translation of the Commentaries on the OECD MC – made under the sponsorship of the International Division of the SAT – and pointed out that according to paragraph 5 of the Commentary on Article 8, *’profits obtained by leasing a ship or an aircraft on charter fully equipped, manned and supplied must be treated like the profits from the carriage of passengers or cargo.’* That is, rental income under a wet lease falls directly under the scope of Article 8, and need not be classified as a form of ’ancillary income‘. Moreover, Plaintiff cited another SAT document from 2002, which explicitly stated that, for China’s business tax purposes, wet leases (international or domestic) are treated as a form of transportation business.[7]

Defendant’s response to this counter-argument was striking, and crucial to the case. It claimed that Plaintiff was mistaken in claiming the Circular 241 aimed at reflecting understandings articulated in the Commentaries to the OECD MC. It pointed out that that the OECD Commentaries were not binding documents. Indeed, it claimed that the Commentaries were to be consulted for treaty interpretation only by OECD Member countries, and China was not an

[6] Huancui Judgment, 4.
[7] *Id.*, 5. The Chinese business tax is a VAT-complement and is imposed on the supply of services as well as the transfer of intangible property and real property. The business tax circular cited by Plaintiff was SAT, Notice Regarding Business Tax Administration with Respect to Transportation Enterprises (*Guoshuifa* [2002] 25, 12 Mar. 2002).

OECD member. In Defendant's view, the relevant paragraph of the OECD Commentary was in conflict with Circular 241; there were 'fundamental differences' between the positions contained in the two sources, and only Circular 241 was applicable.[8] Less importantly, Defendant argued that the 2002 circular cited by Plaintiff, being devoted only to the business tax, had no bearing on the dispute in question.

The Huancui Court held for Defendant. Its reasoning was brief, as could be expected from a civil law court. But the judgment, like Defendant's position, also rested crucially on a categorical rejection of the relevance of the OECD MC and Commentaries. The Court wrote: *'China is not an OECD member country; the content of the OECD Model Convention and Commentaries can be neither the basis nor the supporting argument for Defendant's tax collection.'* [9]

II. Related Developments

It is unknown whether Plaintiff appealed the initial court decision.[10] Certain procedural irregularities could have presented complications: in cases involving foreign parties and difficult issues of legal interpretation, Chinese law typically requires judicial review in the first instance to be conducted in intermediate courts, instead of at a lower court such as the Huancui District Court.[11] But an important factor that Donghwa would presumably want to take into account in deciding whether or not to appeal was the SAT's recent

[8] Huancui Judgment, 5.
[9] *Ibid*, 7.
[10] Oddly, although the initial court judgment was dated September 2010, two sources report the decision as delivered only in November 2010. See China Taxation News Report & J. Grocott, 'Foreign taxpayer takes dispute through Chinese courts," International Tax Review, 13 December 2010.

[11] Administrative Litigation Law (National People's Congress, promulgated 4 Apr. 1989, effective 1 Oct. 1990), Art. 14(3); Supreme People's Court, Provisions Regarding Certain Jurisdictional Issues in Administrative Lawsuits (Fashi [2008] 1, 14 Jan. 2008).

position regarding international transportation income. The *China Taxation News Report* all but implied that the SAT stood behind Defendant. There are other, more direct pieces of evidence that the SAT believes rental income under wet leases is not per se income covered under Article 8.

In July 2010 the SAT adopted a comprehensive annotation of the China-Singapore treaty and released it to the public in September.[12] In issuing these Annotations, the SAT intends that (1) where the corresponding provisions of other tax treaties entered into by China are identical, the interpretations offered in the Annotations would also apply; and (2) where there is any discrepancy between the Annotations and previous documents concerning the interpretation and application of tax treaties, the former would prevail.[13] For these reasons, the Annotations have been viewed by many Chinese tax practitioners as having the status of the official 'technical explanations' to all of China's treaties.[14] One section of the Annotations offered certain interpretations of Article 8 of the China-Singapore DTC. That article is actually unusual relative to China's other treaties in containing a fourth paragraph, which states: *'For the purposes of this Article, profits from the operation of ships or aircraft in international traffic shall include: (a) profits from the rental on a bareboat basis of ships or aircraft; and (b) profits from*

[12] *Guoshuifa* [2010] 75 (SAT, 16 July 2010) [Annotations on the Provisions of the Agreement between the Government of the People's Republic of China and the Government of the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and of the Protocol thereto][the 'Annotations']

[13] *Ibid.*, Preamble. There is some ambiguity as to whether the Annotations merely supersedes other existing general treaty interpretations that are inconsistent with it, or whether it is supposed to supersedes existing interpretations of particular other treaties. See, e.g., PricewaterhouseCoopers (PWC), 'Departmental Interpretation Notes Series (I) - A milestone in the development of China's double tax agreements,' *China Tax/Business News Flash* 16 (2010) <http://www.pwccn.com/home/eng/chinatax_news_sep2010_16.html> accessed July 21, 2011.

[14] *Id.* China does not have a published model treaty and there is no other comprehensive explanation of the provisions of the tax treaties that China has entered into.

the use, maintenance or rental of containers (including trailers and related equipment for the transport of containers), used for the transport of goods or merchandise; where such rental or such use, maintenance or rental, as the case may be, is incidental to the operation of ships or aircraft in international traffic.' In other words, the treaty explicitly codifies certain aspects of international practice, whereas they have previously only been stated in places like the OECD Commentary on Article 8.[15]

However, in its annotation of this article, the SAT inserted, to the list of income 'incidental' to the business of international transportation, *'rental income obtained from the lease of ship or aircraft (including all equipment, personnel, and supplies) in the form of wet lease.'* This seems to imply that, contrary to the OECD Commentary, income from wet leases is not *per se* 'international transportation income'. Moreover, the SAT's annotation states that a foreign shipping operator's activities other than 'proper' international transportation should generally generate no more than 10% of its total gross income, in order for such activities to be regarded as incidental to international transportation. Tax agencies are also instructed to consider what the main business of a treaty benefit applicant is stated to be in its business registration when judging what activities of the enterprise are 'incidental'.[16] This is precisely the method of analysis adopted by Defendant in the *Donghwa* case.

Indeed, this approach to applying Article 8 (the article on shipping and air transport) of China's treaties is also adopted in successive versions of a draft *'Regulation on Tax Administration with Respect to Non-Resident Enterprises Engaged in International Transportation'* circulated by the SAT in the fall of

[15] See para. 4.1 to para. 9 of the Commentary on Article 8 of the OECD MC (2010)
[16] The Annotations, Art. 8, para. 4. For a critique of these aspects of the Annotations, see PWC, 'Departmental Interpretation Notes Series (VI) - Clarifications on the article concerning shipping and air transport under double tax agreements: more answers or confusion?' *China Tax/Business News Flash,* no. 23 (2010) <http://www.pwccn.com/home/eng/chinatax_news_dec2010_23.html> accessed July 21, 2011.

2010:[17] rental income from wet leases is to be treated as exempt under Article 8 only if it is ’incidental‘ to activities of international transportation. The reiteration of a formulation adopted in the earlier Circular 241 suggests that whether or not the SAT intended a ’fundamentally different‘ interpretation of what constituted exempt income under Article 8 back in 1998, that is likely its intention now. The *Donghwa* dispute cannot be viewed just as a fluke.

It is not known how South Korea, an OECD Member country and presumably committed to following the recommendations of the OECD Commentary with respect to income from wet leases, has reacted to the *Donghwa* case. Nor is it known how Singapore has reacted on the similar issue raised by the SAT’s Annotations.

III. Legal and Policy Analyses

The blunt dismissal, by Defendant and the Court in the *Donghwa* case, of the relevance of the OECD MC and Commentaries is, to say the least, problematic. After all, the primary documentation of the international practice of treating income incidental (or ’ancillary‘ or ’auxiliary‘) to international transportation as falling within the scope of Article 8 is probably the OECD Commentary on Article 8.[18] Circular 241, issued by the SAT in 1998, not only purported to adhere to that practice but directly borrowed from the OECD Commentary in giving examples of auxiliary activity income.[19] More,

[17] Document on file with author.

[18] Such practice is arguably not apparent from the ’ordinary meaning‘ of the versions of Art. 8 in most treaties - as mentioned above. Art. 8(4) of the China-Singapore DTC is an exception in this regard. On the other hand, in a wet lease, the lessor arguably ’operates‘ the ship leased within the ’ordinary meaning‘ of the definition of international traffic under Art. 3.

[19] These examples followed closely the 1997 OECD MC on Art. 8, paras 7 to 11: e.g. sale of passage tickets on behalf of other enterprises; the operation of a bus service connecting a town with its airport; transportation of goods by truck connecting a depot with a port or airport; inland transportation delivering goods directly to the consignee; lease of containers; and the keeping of a hotel for no other purpose than to provide

generally, the SAT has borrowed heavily from the OECD Commentaries in its interpretations of tax treaties over twenty-five years,[20] and has more than once directly referred to the OECD and UN Commentaries in published circulars.[21] China has also stated numerous non-Member country positions regarding the OECD Commentaries, though never concerning the Commentary on Article 8. Indeed, if the OECD Commentaries had absolutely no relevance for interpreting China's treaties, it is not clear *what* shared understanding formed the basis of China's treaty negotiation with other countries.

An alternative view is that the Chinese government – through the collection decision in the *Donghwa* case and circulars such as the Annotations on the treaty with Singapore – has breached its treaty obligations. This conclusion, of course, is also quite troubling. I have explored the implications of such *prima facie* treaty breaches for foreign taxpayers and governments elsewhere,[22] and will not dwell on them here. Instead, the remainder of this essay examines, in a preliminary fashion, the merit of China's incipient approach to taxing international transportation income as a policy matter, putting aside legal norms.

In the *Donghwa* case, Plaintiff had no establishment in China under Chinese domestic law nor a permanent establishment under the Treaty. If Article 8 of the China-Korea DTC does not apply to the rental payment under a wet lease, China has the right to tax it as a result not of the article on business profit, but

transit passengers with night accommodation. But Circular 241 did not adopt the OECD list in its entirety: for example, income from advertising and commercial propaganda was not listed.

[20] I give many examples of this in 'China', forthcoming as Ch. 8 in M. Lang et al. (eds.), *The Impact of the OECD and the UN Model Conventions on Bilateral Tax Treaties* (Cambridge: Cambridge University Press, 2012)

[21] See, e.g. SAT, Notice on Issues in Determining the Presence of a Permanent Establishment under Tax Treaties *(Guoshuifa* [2006] 35, 14 Mar. 2006). The discussion of wet leases in the OECD Model Commentary on Art. 8 has been incorporated in the corresponding sections of the UN Model Commentary.

[22] W. Cui, 'The Importance of Foreign Administrative Law in International Taxation: an Illustration through Tax Treaty Disputes in China', manuscript available at http://works.bepress.com/wei_cui/6/ (accessed July 21, 2011)

of the royalties article. In many (though by no means all) of China's treaties, including the treaty with Korea, payments received as a consideration *'for the use of, or the right to use, industrial, commercial or scientific equipment'* are taxable under that article, and this is where the primary significance of the purported non-applicability of Article 8 lies. To a considerable extent, then, the policy issue raised by the controversial treatment of wet leases is similar to a better-known controversy that has arisen not only in China but also in certain other countries (e.g. Mexico), namely the taxation of income from satellite transmissions.[23] In both sets of cases, services rendered entirely outside the country of the service recipient is made taxable in that country, whether through an explicit treaty provision, or indirectly through the claim that income is received not for services but for the rental of equipment.[24]

In evaluating the reasonableness of China's (and other countries') decision to impose a tax in this manner, it is useful to consider the tax' economic incidence. To start, we may examine an extreme case, where the service recipient – the Lessee under a wet lease, or the party who hired the satellite transmission service (e.g. China's government television station trying to broadcast its programmes worldwide) – is a price-taker: it must pay the going price for the service that is provided in the international market lying outside of its borders. In this case, the tax imposed by the service recipient's country will likely be borne by the service recipient itself. (A direct manifestation of this would be a tax gross-up under the wet lease or satellite transmission agreement.) The service provider therefore is not hurt by the tax. If the service provider's home country practices exemption with respect to this form of income, then the provider bears no tax in either country. If the provider's home country practices worldwide taxation but generally offers foreign tax credits, then even if the foreign tax credit is denied for the tax paid in the service recipient's country (e.g. because the tax was collected in violation of

[23] See the discussion of the *PanAmSat* case in Cui, 'China', note 19 *supra*.
[24] The OECD's position, of course, is that income from satellite transmissions does not fall under the category of royalty income in tax treaties. See the 2009 OECD Model Commentary on Art. 12, paras 9.1-9.3.

treaties), there is no economic double taxation of the service provider.[25] To put it differently, where a tax imposed by the source country is borne only by the consumers of (or productive factors local to) the source country, there is no real risk of double taxation. In these cases, what the source and residence countries agree to in a treaty is irrelevant, and so is whether the treaty is properly implemented.[26]

Now consider a second extreme scenario, which is unlikely to apply to international shipping or satellite transmission, but may hold true in other circumstances and is worth considering in contrast to the preceding scenario. In this scenario, the service provider, when furnishing a service to recipients in a new country, earns income that is in excess of its marginal cost of production. In economic terms, it extracts a certain amount of location-specific rent from the new country in which it decides to operate. The traditional example of this type is MacDonald's or Starbucks opening up shops in a new country, but if we try to think of services as opposed to the exploitation of trademarks and other intangible property, perhaps Bloomberg News or programs provided by News Corp are suitable examples. In this scenario, if the source country imposes a tax, the tax may be able to reach the locational rent earned by the foreign service provider. If so, even if the residence country also taxes the same income, as long as both countries are taxing infra-marginal profit, no economic harm is caused by 'double taxation'.

What these two examples show is that the restrictions of source countries' taxing powers by tax treaties may have limited significance in certain circumstances: sometimes the source country's decision to tax is self-defeating; at other times the decision is socially optimal. In either of these circumstances, a source country's decision to breach treaty norms with respect

[25] On the other hand, if a credit is given for the tax that is nominally paid by the service provider but actually borne by the service recipient, the provider gets a windfall.

[26] Except to the extent that the treaty source rule helps track the economic incidence of the tax, and prevent a windfall to the service provider, as discussed in the previous footnote.

to particular types of income or transactions, from an isolated policy perspective and neglecting that fact that the decision is norm-breaking, may be said to raise no grave concern.[27]

Of course, it is possible to think of other scenarios where treaty norms are efficiency-enhancing. Consider a third and final scenario of cross-border services, where the service recipient is somehow unique, and dictates the price at which the service is hired from foreign (and domestic) parties: it is a monopsonist. In this case, a tax imposed by the monopsonist's own country will be borne largely (but not exclusively) by the foreign service providers. If the service provider's residence country manages to negotiate a treaty provision that prohibits the monopsonist's country from imposing a tax, then – at the same time as increasing its own tax base (by increasing its service providers' income) – it helps to prevent the source country's further exploitation of an imperfect market.

IV. Conclusion

The *Donghwa* case deserves attention both for the Court's repudiation of the relevance of the OECD MC and Commentaries for China's DTCs, and for its signalling of a new approach to taxing international transportation that the SAT – for now somewhat furtively – is embarking on. In terms of the former, it must be pointed out that just as remarkable as China's position is the lack of response, at least so far, from treaty partner countries. In terms of the latter, this paper suggests that it is useful to try to assess whether the government agency is attempting to capture locational rent, exploit an imperfect market, or merely engaged in a futile form of self-aggrandizement.

(This article appeared in Michael Lang (ed), TAX TREATY CASE LAW AROUND THE GLOBE (Kluwer, 2011))

[27] In fact, in the second type of case, treaty rules may be criticized for preventing efficient taxation.